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STATE FOR E, EB/IFD, AND EUR/SE
TREASURY FOR OASIA - JLEICHTER AND MMILLS
NSC FOR MBRYZA AND TMCKIBBEN

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TAGS: EFIN ECON PGOV TU
SUBJECT: MIXED SIGNALS--OR WORSE--ON STATE BANK PRIVATIZATION

REF: A. ANKARA 1319
¶B. ANKARA 1437
¶C. ANKARA 851

¶1. (Sbu) Summary: According to World Bank and IMF officials, GOT officials up through Economy Minister Babacan have agreed on a strategy to privatize the state-owned Banks. The government will withdraw some state bank capital and gradually shrink the deposit base and government securities portfolio, facilitating Halk Bank's privatization by June 2005 and Ziraat Bank's by December 2005. However, state-owned bank executives have yet to show any signs of preparing to shrink their banks to prepare for privatization, and have taken actions to expand both deposits and loans. The IMF has incorporated the first steps towards downsizing the state banks in its Seventh Review. End Summary.

World Bank Team Engages on a New Strategy:

¶2. (U) A World Bank team has been in Turkey over the past few weeks, working with a GOT interagency committee to analyze how to revive the stalled program of state bank privatization. In the wake of the 2000-2001 crisis, the GOT had to recapitalize the state banks at a cost of 16 percent of GDP. Turkey's post-crisis program with the IFI's called for a shrinkage of the state banks to prepare for their privatization. Over the past year or so, the process has completely stalled. The GOT recently agreed to re-open a dialogue with the World Bank on state bank privatization, as part of its recent re-engagement on a broader array of issues (ref C).

¶3. (Sbu) In a March 10 meeting with econoffs, World Bank Financial Economist Rodrigo Chavez called the state banks the "Achilles Heel" of the economy that stand in the way of the Structural Adjustment Program. He said that the World Bank had come to accept that its initial strategy for privatizing the state banks would not work. Ziraat and Halk Bank hold about thirty percent of government securities, and with their huge balance sheets are unlikely to be marketable in their current form. Moreover, the idea of merging Ziraat and Halk--which do not appear to have complementarities--would probably make it even harder to sell these banks. According to Chavez, the World Bank therefore "took a step backward" and is working on a new action plan or road map.

A New "Road Map":

¶4. (Sbu) The new plan would entail privatizing Halk by June 2005 and Ziraat by December 2005. To reach the point at which these banks could be ready for privatization, a number of actions would be taken to shrink the banks' balance sheets. First and foremost, the state banks would reduce their deposit base by offering lower interest rates and ending their aggressive bidding for deposits. With a recently-adopted law limiting the state's insurance guarantee on all bank deposits over TL 50 billion (about $38,000) in July, the state Banks should offer rates that are lower than their private sector counterparts on a risk-adjusted basis. Chavez agreed with econoff that there was a danger depositors would assign a lower risk to the state-owned banks' implied government backing--hence the need for a risk-adjusted interest rate. In a March 16 meeting, IMF Deputy Resrep Christoph Klingen said the Fund had secured a commitment from the GOT--as part of the Seventh Review--not to allow state

banks to offer either deposit interest rates as high as private banks or loan rates lower than private banks' rates.

¶5. (Sbu) As they run down their deposit base on the liability side, Ziraat and Halk would be able to reduce their outsized government securities portfolio on the asset side by not rolling over securities as they come due. The government securities portfolios would be further reduced as repayment to the Treasury via a withdrawal of a portion of the capital it contributed in 2001 to save the banks. Chavez said the write-down would be for 6 Quadrillion TL ($4.6 billion) at Ziraat and 2 Quadrillion ($1.5 billion) at Halk. Klingen later told econoffs that the GOT had committed to a $3 billion write-down of Ziraat's capital and would write down Halk Bank's capital by $1 billion if the Halk-Pamuk merger was not structured in such a way that Halk "eats" Pamuk's negative net worth. Note: It's not clear why Klingen and Chavez were citing different numbers. End Note. Klingen also pointed out that the overcapitalization of the two banks creates room for expansionary activities that run counter to the shrink-to-privatize strategy.

¶6. (Sbu) Chavez said that the State Banks have been taking substantial interest rate risk, through asset-liability maturity mismatches. With a strong trend of declining interest rates, the banks have borrowed short-term and bought one-to-two year government paper. Though this has frequently meant a negative short-term carry, the banks have made profits from the capital gain at the time of sale. Chavez said that Ziraat Bank's $556 million 2003 profits might have been a small loss were it not for these bets on interest rates. If interest rates come back up, Ziraat and Halk will be badly hurt.

¶7. (Sbu) The road map would also call for the state banks to sharply reduce their lending activities during the transition period, and there would be a detailed analysis of the branch network. Chavez said that, surprisingly, many of the small-town and rural branches of Ziraat and Halk are highly profitable. Since the state banks have little competition in these remote locations, the branches tend to do well from sight deposits and fee income. By contrast, Ziraat's urban branches tend to lose money.

¶8. (Sbu) Chavez confirmed that the GOT and BRSA/SDIF had made a firm decision to integratemerge SDIF-intervened Pamuk Bank with Halk Bank. Instead of having to recapitalize Pamuk Bank, which has a negative net worth, the SDIF would give Pamuk to Halk. Halk would take the useful assets of Pamuk Bank and dispose of the residual, as the SDIF would have had to do anyway. In this way Halk would in effect pay for the Pamuk recapitalization, which it can afford because of its large capital base. The synergies would also help Halk prepare for privatization. Note: Though, on its face, this might appear to work against the strategy, in that the merger would expand Halk Bank's balance sheet, a variety of contacts--Chavez, the IMF's Odd Per Brekk, BRSA V.P. Ercan Turkan, and former BRSA Chairman Engin Akcakoca--have all told econoffs that the deal makes sense because of the synergies between the two banks. According to these contacts, Pamuk Bank's better quality staff and systems would improve Halk Bank. End Note.

IFI-GOT Negotiations:

¶9. (Sbu) According to Chavez and the IMF's Klingen, Economy Minister Babacan and the interagency GOT committee insist they are committed to privatization. Given past missteps, such as the failure of the Vakif Bank privatization (see below), and the interrelationship between state bank privatization and the Treasury's domestic borrowing program, these GOT officials say they want to be very careful to avoid mistakes in the process of privatizing the state banks.

¶10. (Sbu) Chavez explained that the component of the strategy that most worries their GOT counterparts is the impact on Treasury's borrowing program. Though the write-down of capital (via return of government securities to Treasury) would reduce Treasury's debt, the shrinkage beyond the capital reduction would oblige Treasury to replace state bank-held government securities with securities held by the private sector investors (mainly banks) at shorter maturities. Chavez said the World Bank believes that the market could absorb this additional supply of government securities under current conditions: there is strong demand for government paper and the market will gain extra liquidity from the drawdown of Ziraat and Halk time deposits. Chavez asserted that the markets would view government paper as a close substitute for these deposits.

¶11. (Sbu) According to Chavez, the GOT officials want to bring in a third party as a kind of insurance policy that the World Bank knows what it is doing. The Bank is willing to accommodate the GOT by agreeing to bring in an investment bank, provided the terms-of-reference are carefully structured and the investment bank has responsibility to see the privatization through to conclusion. Chavez is preparing a World Bank response for his management's approval along these lines. He is hoping the World Bank and GOT will reach agreement on the terms of reference this spring and conduct a tender to select the investment bank. Given the GOT's track record on privatization and SDIF asset sales, econoff warned of the dangers of the investment bank setting a valuation that would kill the privatization. Chavez and Arslan agreed and claimed the key will be how the terms of reference are structured.

¶12. (Sbu) Perhaps because of the disconnect between GOT actions and words (see below), the IMF has included the first steps towards state bank privatization in its Seventh Review requirements. In a meeting March 16, IMF Deputy Resident Represent Christoph Klingen told econoffs that the GOT had reached agreement with Fund staff on a draft Letter of Intent which included commitment to progress on state bank privatization. In the Letter of Intent itself, Klingen said there is a structural benchmark that the GOT will come up with a State bank privatization strategy , the key elements of which will be publicly announced by mid-June. The Fund is also requiring completion of the Halk-Pamuk merger.

Disconnect with State Bank Managers:

¶13. (Sbu) Meanwhile, the statements and actions of state bank executives, suggest that either they have not yet been reined in by Babacan and the interagency committee or are openly defying the World Bank strategy. In a February 24 meeting with Econoffs, State Bank Board Chairman Zeki Sayin was careful to accept that Halk and Ziraat would eventually be privatized but was otherwise completely out of sync with the shrinkage strategy. By referring to the state banks competing with private banks for deposits and loans, he implied a strategy of growth rather than shrinkage. He emphasizing the banks' "autonomy" from the Government, and claimed the Government was not interfering in the Banks' "restructuring." Sayin said the banks are run by "professionals" whose prerogative includes decisions on interest rates, but claimed these rates were not below the banks' cost of funds. According to Sayin, though the banks were not increasing the number of employees or branches, management was trying to run the banks effectively and profitably so the banks would not be a burden on the state.

¶14. (Sbu) The CEO's of Halk and Ziraat have also made public statements that seem contrary to the IFI strategy. These managers have announced low-interest loan programs for farmers and small businesses in recent months, and talk about their vision for the banks for the year. One private Istanbul analyst reports that a government official told him the GOT strategy for 2004 was for the State Banks to grow their loan portfolios, because the government fears that the State Banks would become unprofitable in this year's lower-interest rate environment. BRSA V.P. Turkan told econoffs Ziraat was offering 1.9 percent monthly interest on consumer loans, undercutting the private banks' 2 percent rate.

¶15. (Sbu) In a series of meetings in Istanbul March 3, several private sector observers told Econcouns that the State Banks have reversed course, and seemed to be trying to grow rather than shrink. They saw the State Banks competing on deposits as well as loans, and attributed at least part of the motivation to Government populism. Baturalp Candemir of HC Istanbul feared the aggressive lending would lead to non-performing loans and said that BRSA Chairman Bilgin had told him that Halk bank had to grow becaus of its important role in the economy. Huseyin Kelezoglu, also of HC Istanbul, said State Bank growth would: a) discourage foreign investment in the banking sector; b) increase State Bank vulnerability to political pressure; and c) hinder the development of the private banks. Former State Bank Board Chairman Vural Akisik also agreed the state banks had reversed strategy. He had heard that Vakif Bank leadership was now saying the bank could not be privatized. Akisik also said the GOT was pressuring the Bankers Association to reverse an Akisik-era reform, which was to shift chairmanship of the Association from Ziraat to one of the private bank executives.

¶16. (Sbu) In subsequent meetings with Istanbul Econoff the week of March 8, a number of Turkish bankers echoed Kelezoglu's concerns and reported additional evidence of Government support for the expansion of State Banks. Huseyin Imece, Executive Vice President at Yapi Kredi, noted that he has heard that state agencies have been directed to shift their deposits from private banks to either Ziraat or Vakif Bank by August. In Yapi's direct experience, Imece said one unnamed state agency recently cancelled its five-year contract with the bank to make the shift. This shift will provide interest-free demand deposits to the State Banks. Imece and others, including Koc Bank CEO Kemal Kaya, noted that the roll-back of the deposit guarantee to cover only accounts up to 50 billion TL will enhance state banks' competitive advantage, given the perception of continued state backing. (While 99 percent of Turkish accounts will be covered under the new policy, in volume terms well over half of Turkish accounts will reportedly not be covered.) In sum, Istanbul's privately-owned banks see the state bank policy shift as an added and unwelcome challenge just as they adjust to a more difficult, low-interest rate environment without easy profits from government securities.

¶17. (Sbu) In the meeting with Chavez, econoff raised the problematic behavior of the state bank managers. Arslan pointed out that this was typical behavior for the managers of State-owned enterprises on the verge of privatization and Arslan attached greater importance to what the World Bank's counterpart technocrats were saying. These executives have a conflict of interest, in that they will lose their jobs from the privatization. While admitting the state bank executives' actions was counterproductive, Chavez said his understanding is that Babacan and the Prime Minister will make the decision on state bank privatization.

The Strange Case of Vakif Bank:

¶18. (Sbu) Chavez saw far greater challenges in moving forward on the privatization of Vakif Bank. An earlier privatization decision on Vakif was overturned by the Constitutional Court, bringing the process to a halt. Chavez said the World Bank team had come to the conclusion that for now, at least, Vakif was not privatizable. He said there were market reasons relating to the structure of the balance sheet but there was also a lack of clarity in the ownership structure. Though it is by law a private bank, owned by a grouping of foundations and by its employee pension fund, Vakif is de facto controlled by the state. Chavez said the key question is how to reduce state control, and believes it could be done through dilution of the existing owners' share in the capital. Chavez said that Vakif CEO Kacar agreed in principle to some dilution, but wanted to keep the foundations' and pension fund's combined share at least at 55 percent. This is unacceptable for the World Bank since it will render any share sale unattractive. According to Chavez, it is not clear whether Kacar really speaks for the GOT on this issue and the World Bank wants Treasury to seek GOT views. Chavez also noted that a Vakif privatization would require the approval of a broader array of actors than for Ziraat and Halk: In addition to Babacan, Deputy Prime Minister Sahin (also Labor Minister) would have to sign, representing the owners. The SDIF would also have to approve, under the conditions of a subordinated loan SDIF granted Vakif. Finally, the pension fund would have a say since it has a 25 percent blocking minority.

¶19. (Sbu) Klingen said the IMF Letter of Intent is also committing to the completion of due diligence on Vakif Bank by June 30, to be followed by a decision on how to dilute Vakif's capital.

Comment:

¶20. (Sbu) Comment: Though the World Bank's strategy seems reasonable, and the renewed GOT engagement an improvement from the previous stalemate, the disconnect between state bank management actions and the World Bank's dialogue is troubling. Part of the problem may be that, until now, the state bank managers simply had not received the word yet, and will soon be reined in by their ministerial overlords. It is also possible, however, that the state bank managers have some ministerial support for their actions, i.e. that Babacan has not yet built broader support for the privatization. End Comment.